So, again, the American people do not want the United States Government to micromanage elementary and secondary schools. They do not want them to mandate to their elementary and secondary schools. They do not want them to interfere with the operation of their elementary and secondary schools. They realize that one cannot bring quality from top down. We have to build it from bottom up. And they know that the local parents, the local teachers, the local students and the local elected officials know far better than Washington, D.C., what is in the best interests if we want to really have quality education in their particular district. One size fits all from Washington, D.C., has never worked, will never work.

And, again, I want to emphasize the tremendous effort made in this Congress to try to do what we could do to give the local schools an opportunity to improve their own school system.

One of the things the gentleman in the chair brought to this Congress was the whole idea of getting dollars down to the classroom. Getting them beyond the bureaucracy in Washington, getting them beyond equally bureaucratic State governments, down to the classroom. That is where we make the difference, and that is what we wanted to do. And what do we get for our effort? A veto threat.

Well, that is the only way it will work. This administration has to understand, we build from the bottom up. The programs are there. We do not need to take old programs and give them a new name. I made it very clear to the White House last year, the year before and this year that if you want to be a hero, if you really want to be remembered in the area of education, do something to help us fund the 40 percent of excess costs for special education; and the local district will then be able to take their money to provide a quality education for all students.

The SPEAKER pro tempore (Mr. PITTS). Under the Speaker's announced policy of January 7, 1997, the gentleman from Iowa (Mr. LEACH) is recognized for the remainder of the majority leader's hour, approximately 35 minutes.

THE FAILURE OF LONG-TERM CAPITAL MANAGEMENT: A PRELIMINARY ASSESSMENT

The SPEAKER pro tempore. The gentleman from Iowa (Mr. LEACH) is recognized for the remainder of the Majority Leader's hour, approximately 35 minutes.

Mr. LEACH. Mr. Speaker, I rise to discuss one of the most serious and symbolic financial events of the decade: the failure and government-led rescue of America's largest and most heavily leveraged hedge fund, Long-Term Capital Management.

Dubiously enshrined in establishment economic thinking is the too-big-to-fail doctrine, the notion that government will intervene to save a bank in trouble if its collapse would cause major harm to the economy.

Last month, with the rescue of Long-Term Capital Management, a corollary appears to be in the making that "some financial firms are too big to liquidate too quickly." The application of the "too-big" doctrine for the first time beyond a depository institution raises troubling public policy questions.

From a social perspective, it is not clear that Long-Term Capital, or any other hedge fund, serves a sufficient social purpose to warrant government-directed protection. In one view, hedge funds provide liquidity and stability in financial markets, allowing economies to finance infrastructure and enterprises necessary to modernize. In another view, hedge funds have a raison d'etre: They seem to be run-amok, casino-like enterprises, driven by greed with leverage bets of such huge proportions that they can control global capital markets and even jeopardize economic viability of individual sovereign States.

In this case, the country's most sophisticated banking institutions provided loans to an institution that shielded its operations in secrecy, denying lenders and their regulators data about its positions or other borrowings. The rationale was that sharing information was competitively disadvantageous to the fund. Lenders to the fund, in effect, became responsible for a kind of blind-eyed complicity and speculative actions that might in some cases prove destabilizing for the very financial system upon which banks and the public rely.

The envy of its peers, Long-Term Capital was the very paragon of modern financial engineering, with two Nobel Prize winners among its partners and Wall Street's most celebrated trader as its CEO. The fact that it failed does not mean that the science of risk management is wrong-headed; just that it is still an imperfect art in a world where the past holds lessons but provides few reliable precedents.

Hedge funds were so named because their managers tried to reduce with offsetting transactions the risks they take with investor funds. Today, the name has an ironic ring. As hedge funds have grown in the last few years, so has the venturesome nature of their investments in pursuit of higher returns. The industry numbers between 3,000 and 5,500 funds, with somewhere between $200 billion and $300 billion in investment capital, supporting book assets in the order of $2 trillion. About a third of the funds are highly leveraged; in Long-Term Capital's case, about 27-to-1 when its books were solid; more so when difficulties emerged.

Large financial institutions make this leveraging possible, often with federally-insured funds. If taxpayers are to share in the risk, they or at least their protectors, bank, securities, and commodities regulators, ought to understand what stakes are involved. The profit motive is the most powerful disciplinarian of markets, but the United States Government is obligated to be on top of the issues.

There are points where politics and economics intersect; and when political institutions implode, as they have in Russia, economic consequences follow. The best and the brightest on Wall Street lost billions betting that Russia was too nuclear to fail. They did not grasp that it was too corrupt to succeed and that it did little good for the West to transfer resources to Russia's Central Bank if it simply recycled them to a private banking system which served as the money-laundering network for insiders.

No nation-state can prosper if it lacks a place where people can save their money with confidence and seek lending assistance with security. Russia, which is the landmass most similar to our own, has been kept back for most of this century because of the Big "C", Communism, and is now in a despairing state because of the little "c", corruption, which is likely to be more difficult to root out than Communism was in the first instance.

It is bewildering how, with all of the attention in recent months being given to forming a new global financial system architecture, no one is paying attention to universal values. Honesty must prevail over corruption, or no financial system will work. In fact, unless the point is made with regard to countries such as Russia that the problem is not that market economics are wanting but that corrupt market mechanisms are pervasive, the Russian people will never understand the lessons of the century. The old battleground in world affairs was Communism versus Capitalism; the new one contrasts corrupted market economies versus noncorrupted ones.

What the Russian people, and those of so many developing countries, deserve is a chance to practice free market economics under, not above, the rule of law. If attention is paid above all to establishing honest, competitive institutions of governments and finance, virtually everything else will fall into place.

From the public's perspective, it must be understood that politicians can be dangerous and that their most counterproductive weapon is protectionism. This is particularly true in finance. Any country that protects itself from foreign competition and finance injures itself and, in effect, emboldens corruption. Unilateral decisions or international agreements to open markets that are closed to Western-system financial institutions provide the best chance for corrupt systems to reform themselves. Their public will, if given a chance, lead their leaders by saving where they are best protected and borrowing where they get the most competitive terms.

In Long-Term Capital's case, the underestimation of the role of corruption in Russia and other emerging economies led to an underestimation of the American economy and legal system.

The mathematical model Long-Term Capital followed apparently assumed market tranquility. If certain bond yields relative to Treasuries widened, it predicted that market forces would correct the differential and yields would inevitably begin to converge. As spreads began to widen earlier this year, the fund bought long corporate and foreign bonds at the same time it sold short Treasury instruments. But when a flight to quality escalated, the spreads widened, rather than narrowed, and Long-Term Capital found itself on the losing end of both sides of key investment equations.

At issue is not just a judgment of the moment but the problem of developing with confidence risk models for adverse times, especially when the vicissitudes of politics and human nature conspire with market forces.

At issue also is the possibility that the failure of Long-Term Capital reflects the bringing home to the United States the economic problems of the rest of the world. As Wall Street firms have begun to move to protect themselves in recent weeks by pulling in credit lines and dumping less solid investments, a crisis of confidence appears to be developing. The impending credit crunch requires a monetary response from the Fed, i.e., immediate attention to lowering interest rates and, perhaps, a shot of fiscal stimulus from Congress, preferably a tax cut of modest dimensions on the order of the $16 billion a year one that passed the House last month.

I was initially informed by a top Treasury official that there was a distinction between being informed and being consulted on the Long-Term Capital issue and that while Treasury had no disagreement with the judgment or the role of the Fed, Treasury's involvement could only be characterized as passively being informed of Fed concerns for the systemic implications of a fund failure in the economy.

Minutes prior to the October 1 Committee on Banking and Financial Services hearing on Long-Term Capital, I received a letter from Treasury Deputy Secretary Summers, which in amplification stated:

> We were informed of the developments affecting Long-Term Capital Management, and we were kept apprised of the progress of discussions among its creditors. We did not, however, participate in any of these discussions.

I was therefore surprised to learn in testimony from New York Federal Reserve Bank President William McDonough that he confirmed directly with Treasury Secretary Rubin on September 18 and that he was joined by Assistant Treasury Secretary Gary Gensler in discussions with Long-Term Capital's partners in Long-Term Capital's offices on September 20, the day prior to McDonough's decision to intervene in a role he analogized that played by J.P. Morgan in the panic of 1907. Given this circumstance, the ''informed/consulted'' distinction would appear to tilt to the ''consulted'' side.

While oversight of bank lending to Long-Term Capital Management and financial instrument trading within the firm does not appear to have been governmentally coordinated, its bailout was.

In retrospect, it is difficult not to be struck by the fact that the shrewdest in the hedge fund industry could commit such investment errors, that the most sophisticated in banking would give a blank check to others in an industry in which they considered themselves to be experts, and that the United States regulatory system could be so uncoordinated and so easily caught off guard.

□ 2100

The Fed and the Comptroller of the Currency, principally the Fed in this case, had responsibility for regulation of the banks which extended such large credit lines to Long-Term.

Questions exist as to how knowledgeable of loan extensions were the regulators. The principal agency with statutory authority over the fund's trading practices was the Commodity Futures Trading Commission, with which Long-Term Capital was registered as a commodity pool operator, and to which it was required to make periodic financial disclosures.

According to CFTC officials, the Commission has the power to examine the firm's trading positions, yet apparently it did not do so, even after Long-Term Capital reported at the end of 1997 that its assets included nearly $3 million in swaps, forwards, futures, options, and warrants, and its liabilities, $6.4 billion in similar instruments, or that it had leveraged $4.7 billion in partners' capital into investments of $129 billion.

While regulators appear to have egg on their face for the failure as well as the rescue of Long-Term Capital, risk-free regulation is not possible or necessarily appropriate. The economy could be as ill-served by financial institutions refusing to take risks as it would be by those taking too much. But Congress cannot duck its oversight responsibility of those charged with supervision of these markets.

That is why 5 years ago I issued a 900-page report on the financial derivatives marketplace which included a series of 30 recommendations for regulatory guidance to constrain systemic risk in a market which I then described as ''the new wild card in international finance.'' In this report, I noted that, ''Historical experience is not always a guide to the future, especially when a relatively new market explodes in size'' and when there are ''unprecedented economic uncertainties.''

Among the recommendations in the report, which became one of the benchmark assessments of how derivatives should and should not be regulated, were that bank regulatory agencies should discourage active involvement in derivatives markets by insured institutions unless management can convincingly demonstrate both sufficient capitalization and sophisticated technical abilities. Greater transparency and uniform disclosure standards were also recommended.

The troubles of Long-Term Capital presented the Fed with a dilemma. If it failed to act in the face of what is presumably deemed to be systemic risk, it would have been left open to charges that it abdicated leadership on a matter that might have affected the stability of markets around the world, and thus, the pocketbooks of millions of ordinary citizens.

By acting as it did, however, it preserved an institution that in a free market economy would normally have been allowed to fail. The Federal Reserve's decision to intervene in the Long-Term Capital situation underscores that the Fed operates under two basic pinions: that low inflation is always a friend, and that instability is always the enemy.

Clearly, the Fed will go to great lengths to reduce the dangers of instability, as well as inflation. But the government's intrusion into our market economy can be justified only if it can be credibly shown that there is a clear and present danger to the financial system in Long-Term Capital's failure, and that there were no stabilizing alternatives, other credible bids on the table, or other approaches to ensure that a market-shaking unwinding did not occur.

In this case, another bid was on the table. According to Mr. McDonough, it was rejected by Long-Term Capital's management because it did not have the legal ability to accept it, although it had the ability to accept the alternative, which reportedly included a commitment to keep the management of Long-Term Capital intact.

Here it deserves noting that in the wings was not only a ''Warren Buffett'' in terms of an alternative bid, but a ''Paul Volcker'' or ''Jerry Corrigan'' in terms of a possible court-appointed bankruptcy trustee.

I stress the bankruptcy laws because, to the extent that another hedge fund of similar size or group of companies that, in combination, may be of comparable importance could get into trouble, the U.S. bankruptcy laws are designed to stabilize insolvent circumstances. Indeed, under the bankruptcy code, a trustee probably has more authority to proceed slowly than a reengineered company not protected by bankruptcy status.

With regard to a future government role in bankruptcies of hedge funds or other financial institutions, the Fed might want to think through the possibility of making process recommendations to bankruptcy courts. For instance, if a significant fund fails, the Fed should prepare to go to a court and recommend a given type of process, as well as consideration of particular types of or actual individuals who might be appropriate to serve as trustees for a failed fund.

If the problem relates to systemic concerns and the goal is an orderly unwinding of positions or orderly transfer of assets, the Fed is obligated to lend a perspective to the courts.

Given that almost any future potential failure of another fund will raise questions of whether it will be given like treatment as Long-Term Capital, the Fed or Treasury should also consider issuing public guidelines or commentary about their intent to rely on orderliness through bankruptcy statutes to assure markets that unfortunate problems will not become systemic liabilities.

In this regard, balance should be emphasized. Just as there may be systemic concerns for a too rapid unraveling of positions, there could be competitive and market concerns for too prolonged resolution of the problem.

It is a particular umbrage that the hedge fund bailed out under the Fed's leadership operate commodity pools organized as Cayman Islands entities. Implicit in this circumstance is the possibility that individuals who presumably sought to reduce their United States tax obligations through Caribbean shelters could find their assets protected with the help of a United States government agency.

To the degree doubt exists, because of the Cayman connection, whether U.S. bankruptcy laws could effectively have been applied in the Long-Term Capital situation, or whether actions might be brought in other jurisdictions, Long-Term Capital's problems underscore the legal risk issue. Prudent banks should have doubts about lending to institutions whose operations may not be within the full reach of the laws of the United States or other comparable legal systems.

While the goal of the Fed's intervention was to avert a short-term shock to the international economic system, it appears that a more serious long-term threat may be the result. Today we have a reconstituted fund that is co-owned by 14 of the world's largest financial institutions, from Travelers and Merrill Lynch to J.P. Morgan and the Union Bank of Switzerland.

In this regard, it should be understood that the coordinated government bailout approach which was undertaken may involve a tendency towards concentration with the new owners conjoined as a group having a greater impact on markets than in competition with one another. The Fed's unprecedented extension of the too-big-to-fail doctrine to a hedge fund does not insulate the fund and its new owners from the constraints of the Sherman and Clayton Acts.

Working as a cartel, those running Long-Term Capital potentially comprise the most powerful financial force in the history of the world, and could influence the well-being of Nation states for good or for naught, guided by the profit motive, rather than national interest standards.

This dilemma is reflected in the announcement the week after the Fed intervened by the Secretary of the Treasury that the United States government and international resources should be put in play to prop up certain foreign currencies. Most analysts assume the Treasury was particularly concerned that the Brazilian cruzeiro might be devalued. But to give a governmental imprimatur to the fund as it is now constituted could cause conflicts of interest not only among its owners, but with our own government. The possibility that taxpayer dollars might be pitted in the future against those of a firm the United States government helped rescue could be an expensive irony.

The antitrust laws are generally applied to concentration in a particular market sector, but the combination of many of the world's most sophisticated financial powerhouses in hedge fund activities is unprecedented in significance. Such a combination, if allowed to stand, could enable these institutions to hold sway over whole economies. No central bank or finance ministry in the world could match the assets they could wield in currency markets.

Further complicating this collusion problem is the report that half-a-dozen or more government-owned banks are or have been strategic investors in Long-Term Capital.

The possibility that fund managers might receive insider information from their own investors who represent foreign governments; or that any government would think it appropriate to invest public monies in a speculative hedge fund; or that our government might be put in the position of having to decide whether to rescue a fund which, if liquidated, might embarrass a government with which we interrelate on many issues, is bizarre and untenable.

As powerful as they are, Long-Term Capital's new owners are confronted with a legal Catch-22. If they do not actively manage the fund, they could be sued for lack of prudential stewardship. If they do actively manage the fund, they could be sued for collusion.

In testimony before the Congress last week, Fed officials said firewalls would be established to separate the fund's oversight committee managers from their home offices. However, firewalls, no matter how high, are particularly vulnerable when losses mount. If hedged positions improve, legal liabilities could be bedeviling.

If, for instance, Long-Term Capital and any of its new investors were to take a position that would prove profitable, presumably someone on the unprofitable side of such a position might sue on collusion grounds. Or if it were to pay back a creditor partner and not a creditor non-partner, questions of equity could be raised.

The Long-Term Capital saga is fraught with ironies related to moral authority as well as moral hazard. The Fed's intervention comes at a time when our government has been preaching to foreign governments, particularly Asian ones, that the way to modernize is to let weak institutions fail and to rely on market mechanisms, rather than insider bailouts.

We have also encouraged developing countries to establish bankruptcy arrangements to cushion the shock of failures, and, where possible, fairly distribute the assets of bankrupt institutions. Now, as the country with the most sophisticated markets, bankruptcy laws, and legal precedents, we appear to have abandoned the model we urge others to follow.

Worse yet, the Federal government appears to have played a role in precipitating a bailout offer that was more advantageous to the failed management than that which the free market offered. Warren Buffett may be fortunate to have had his bid for Long-Term Capital turned down in favor of the government-coordinated effort. Given reports of further erosion of Long-Term Capital capital, the new owners and the government, on the other hand, may be embarrassed if stabilization of the fund requires another rescue.

It will be months before proper perspective can be applied to this unique circumstance, but the principal lesson would appear to be that the Fed should rely more extensively on market mechanisms and America's sophisticated bankruptcy laws. Above all, the public should be assured that the government will not subsidize insider bailouts, or protect those who make investment errors. The too-big doctrine is simply too prone to fail.

TRIBUTE TO JOSEPH P. KENNEDY, II, MEMBER OF CONGRESS

The SPEAKER pro tempore (Mr. PITTS). Under the Speaker's announced policy of January 7, 1997, the gentleman from Massachusetts (Mr. MOAKLEY) is recognized for 60 minutes as the designee of the minority leader.

Mr. MOAKLEY. Mr. Speaker, I rise to pay special tribute to my colleague and my very dear friend, the gentleman from the Eighth Congressional District, the gentleman from Massachusetts (Mr. JOE KENNEDY).

When JOE was first elected to the 100th Congress back in 1986, he had a lot to live up to, and he has done so with Irish passion and a devotion to those less fortunate that would have made his father very proud.

First, JOE had to confront enormous expectations because of who he was. As the oldest son of the late Senator Robert Kennedy, as the nephew of Senator EDWARD KENNEDY, and the nephew of President John F. Kennedy, he was expected to do great things.

If those expectations were not already high enough, JOE had the